GEORGE E. GREER (*admitted pro hac vice*)
LORI LYNN PHILLIPS (*admitted pro hac vice*)
JOSHUA B. SELIG (*admitted pro hac vice*)
HELLER EHRMAN LLP
701 Fifth Avenue, Suite 6100
Seattle, WA 98104-7098
Telephone: (206) 447-0900
Facsimile: (206) 447-0849
george.greer@hellerehrman.com
lori.phillips@hellerehrman.com
joshua.selig@hellerehrman.com

CHAD R. FULLER (Bar No. 190830)
HELLER EHRMAN LLP
4350 La Jolla Village Drive, 7th Floor
San Diego, CA 92122-1246
Telephone: (858) 450-8400
Facsimile: (858) 450-8499
chad.fuller@hellerehrman.com

Attorneys for Defendant
PRICEWATERHOUSECOOPERS LLP

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF CALIFORNIA

HCL PARTNERS LIMITED PARTNERSHIP, on behalf of itself and all others similarly situated, Plaintiff, v. LEAP WIRELESS INTERNATIONAL, INC., S. DOUGLAS HUTCHESON, AMIN I. KHALIFA, GRANT A. BURTON, MICHAEL B. TARGOFF, JOHN D. HARKEY, ROBERT V. LaPENTA, and PRICEWATERHOUSECOOPERS LLP, Defendants.	Case No.: 07cv2245 BTM (NLS) **MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT OF DEFENDANT PRICEWATERHOUSECOOPERS LLP'S MOTION TO DISMISS PLAINTIFFS' CONSOLIDATED CLASS ACTION COMPLAINT** DATE: November 21, 2008 TIME: 11:00 a.m. CTRM: 15 The Hon. Barry Ted Moskowitz
KENT CARMICHAEL, Individually and on behalf of all others similarly situated, Plaintiff, v. LEAP WIRELESS INTERNATIONAL, INC., S. DOUGLAS HUTCHESON, AMIN I. KHALIFA, GRANT A. BURTON, MICHAEL B. TARGOFF, JOHN D. HARKEY, ROBERT V. LaPENTA, and PRICEWATERHOUSECOOPERS LLP, Defendants.	Case No.: 08cv0128 BTM (NLS) No Oral Argument Unless Requested By The Court

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I. INTRODUCTION

Plaintiff alleges that PricewaterhouseCoopers LLP ("PwC") made false statements when it issued its audit opinion concerning the financial statements of its client Leap Wireless International, Inc. ("the Company" or "Leap") for the year 2006. Plaintiff's claim against PwC must be dismissed because it does not meet the heightened pleading standard that applies to claims for securities fraud. Under the Private Securities Litigation Reform Act ("Reform Act" or "PSLRA") and Federal Rule of Civil Procedure 9(b), Plaintiff is required to state with particularity facts giving rise to a strong inference that PwC acted with an intent to deceive Leap's shareholders when it issued its audit opinion. Accordingly, Plaintiff must allege detailed facts creating an inference that is "more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2504-05, 2510 (2007). The facts alleged by Plaintiff do not meet that test.

The allegations against PwC do not allow any conclusion to be drawn about PwC's state of mind. The Complaint describes accounting deficiencies at the Company, but the law is well settled that accounting or auditing mistakes do not equate to strong evidence of an intent to deceive. *See* Section III.B.1 below. Plaintiff lists a number of "red flags" supposedly ignored by PwC, but there is nothing in Plaintiff's vague allegations about these supposed "red flags" (which are not red flags at all) that creates a strong inference of scienter. *See* Section III.B.2. The Complaint's heavy reliance on anonymous "confidential" witnesses also diminishes the force of any inference of intent to deceive. Those allegations should be steeply discounted because they lack the required level of detail. *See* Section III.B.3. The Court may also consider on this motion the disclosures that were made in other SEC filings of the Company, which undermine Plaintiff's theory that PwC was engaged in fraudulently covering up corporate error or fraud with Leap's director and officer Defendants. *See* Section III.B.4. Moreover, because Plaintiff has not alleged that any particular individual at PwC had an intent to deceive, it has not pled the scienter element as to PwC. *See* Section III.B.5.

Here the more compelling inference to be drawn from the Complaint and undisputed facts is that the Company and PwC were alert to the weaknesses in the Company's internal controls, disclosed the material weaknesses, and worked to remediate them. They believed the remediation was successful, but later determined that the financial statements contained errors resulting from additional weaknesses in controls, which were disclosed in the restatement announcements.

Under *Tellabs*, the Court should weigh the competing inferences. Because Plaintiff's non-specific allegations of fraud are less compelling than the inference of nonfraudulent behavior, the claim against PwC should be dismissed. *Tellabs*, 127 S. Ct. at 2504-05 (inference raised by securities plaintiffs' allegations does not satisfy Reform Act unless it is "at least as compelling as any opposing inference of nonfraudulent intent").

In addition, Plaintiff's claim against PwC must be dismissed to the extent it is not tied to any alleged misstatement by PwC. The only statement by PwC identified in the Complaint is the audit opinion that was included in the Company's Form 10-K filed on March 1, 2007. There are no statements alleged to have been made by PwC prior to that point in the class period. Accordingly there is no basis for a fraud claim against PwC by individuals who purchased their investments prior to March 1, 2007. Likewise, there is no basis for a claim against PwC in connection with quarterly filings or other alleged statements by the Company or its officers and directors. Those statements are not—and could not be—attributed to PwC.

II. SUMMARY OF ALLEGATIONS AND FACTS

PwC has been Leap's auditor since 2000. Compl. ¶ 34.[1] Auditors do not prepare the financial statements of the companies they audit. Rather, they express an opinion about the financial statements prepared by the company based upon an audit performed under Generally Accepted Audit Standards ("GAAS").[2] Plaintiff's claims against PwC are based entirely on PwC's opinion that was included in the Company's 2006 Form 10-K that was publicly filed with the Securities and Exchange Commission on March 1, 2007 ("2006 Audit Opinion"). *Id.* ¶¶ 6, 160-70. There are no public statements alleged to have been made by PwC prior to (or after) that date within the proposed class period. Although Plaintiff alleges that PwC conducted reviews of Leap's quarterly reports filed with the SEC, it has not identified any public statements by PwC in connection with those filings, because there were none. *Id.* ¶ 34.

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[1] PwC does not admit the truth of any of Plaintiff's allegations described in this memorandum.

[2] *Bily v. Arthur Young & Co.*, 834 P.2d 745, 764 (Cal. 1992) ("[T]he auditor merely expresses an opinion about its client's financial statements . . . .").

Plaintiff alleges that PwC's 2006 Audit Opinion contained two false and misleading statements. First, PwC stated that, in its opinion, Leap's 2006 financial statements were presented in conformity with Generally Accepted Accounting Principles ("GAAP"). Second, PwC opined that management's assessment that the Company maintained effective internal controls over financial reporting was fairly stated. *Id.* ¶¶ 154-56. Plaintiff contends these statements were "false" when made, relying on the fact that the Company later announced a restatement of its 2006 financial statements. *Id.* ¶¶ 155-58. This contention does not clear the high pleading bar set by the Reform Act, however. Even assuming PwC's opinion was in error when viewed with the benefit of hindsight, that is not sufficient to plead scienter. *See In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 988 (9th Cir. 1999) ("Congress enacted the PSLRA to put an end to the practice of pleading 'fraud by hindsight.'"). Plaintiff must allege particularized facts creating a strong inference that PwC acted with a mental state embracing an intent to deceive Leap's investors when issuing its Audit Opinion. *Id.*

The fraud theory that Plaintiff asserts is not only unsupported by particularized facts, it is illogical in light of the public disclosures that the Company and PwC made in earlier periods. Those disclosures show that management and PwC were willing to disclose material weaknesses in internal controls over financial reporting when such weaknesses were detected.

For example, in the publicly filed Form 10-K for 2005, Leap disclosed that its CEO and CFO had concluded that material weaknesses in Leap's internal control over financial reporting existed for each of the quarters from September 30, 2004 through December 31, 2005 with respect to turnover and staffing levels in its accounting, financial reporting, and tax departments.[3] Declaration of Lori Lynn Phillips in Support of PwC's Motion to Dismiss Consol. Compl. ("Phillips Decl.") Ex. A at A3. In addition, it disclosed that material weaknesses also existed as of December 31, 2004 and March 31, 2005 with respect to, among other issues, its "account reconciliation procedures." *Id.* at A3-A4. It openly acknowledged its problems as of that time, stating, "Our internal control over financial reporting has been subject to certain material weaknesses in the past and is currently subject to material weaknesses . . . . Our management concluded and our independent registered public accounting firm [PwC] has attested and reported that our internal control over financial reporting was not effective as of December 31, 2005." *Id.*; *see also id.* at A8-A9 (discussing internal control deficiencies). PwC's opinion that was included with the 2005 Form 10-K noted these weaknesses in the Company's accounting controls. *Id.* at A5-A7.

In its quarterly statements throughout 2006, the Company stated that its CEO and CFO concluded that there were control deficiencies as of March 31, June 30, and September 30, 2006 that resulted in material weaknesses in the Company's internal controls over financial reporting. Those control weaknesses included "insufficient staffing in the accounting, financial reporting and tax functions" and "errors in the accounting for income taxes." *See, e.g.*, Phillips Decl. Ex. B at B11-B12; Ex. C at C14-C15; and Ex. D at D17-D18. The Company acknowledged a lack of "a sufficient complement of personnel with the appropriate skills, training and Company-specific experience to identify and address the application of generally accepted accounting principles," and it described the steps it was taking to remediate these problems. *Id.*. The quarterly reports also continued to note that PwC had determined the controls were not effective as of December 31, 2005. Phillips Decl. Ex. B at B13-B14 and Ex. C at C20.

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[3] The incorporation by reference doctrine "permits a district court to consider documents whose contents are alleged in a complaint and whose authenticity no party questions, but which are not physically attached to the plaintiff's pleading." *In re Silicon Graphics*, 183 F.3d at 986 (internal quotation marks omitted); *see also Tellabs*, 127 S. Ct. at 2509 (courts must consider "documents incorporated into the complaint by reference" when ruling on motion to dismiss). The contents of the documents cited by PwC in support of this motion may be considered by the Court under this doctrine. *See Tellabs*, 127 S. Ct. at 2509 (on motion to dismiss securities fraud claims, court should consider entirety of complaint and matters of which court may take judicial notice); *Dreiling v. Am. Express Co.*, 458 F.3d 942, 946 n.2 (9th Cir. 2006) (SEC filings may be considered on motion to dismiss).

When it filed its 2006 10-K, the Company stated that it believed the material weaknesses in internal controls over financial reporting had been addressed. Phillips Decl. Ex. E at E25. PwC also expressed its opinion that, in all material respects, the Company's internal controls over financial reporting were effective as of December 31, 2006. *Id.* at E26-E27.

On November 9, 2007, Leap announced that it was restating its financial statements for 2004, 2005, and 2006 and for the first and second quarters of 2007. Compl. ¶ 139. As part of that restatement, the Company announced that errors in previously reported service revenues, equipment revenues, and operating expenses required correction. *Id.*

Plaintiff contends that PwC ignored "red flags" that should have alerted it that Leap engaged in "improper revenue recognition practices" and that material weaknesses existed in Leap's internal controls as of December 31, 2006. *Id.* ¶ 36. Even if PwC was aware of these alleged facts, there is nothing about them that should have led PwC to conclude that a material error or fraud was occurring. The supposed "red flags" include:

- Revenue was a high risk area for Leap—an allegation that says nothing about whether the accounting was correct;
- The Company hired outside accounting, auditing, and technical consultants to fill "voids" in its accounting and compliance functions—consistent with the Company's disclosures that it was attempting to remediate the publicly disclosed staffing issues;
- Company management allegedly advised PwC of material weaknesses in Leap's financial reporting, internal controls, and revenue recognition practices that Plaintiff contends were presented to management by outside consultants—an alleged communication that is not identified by date, participants, substance, or any other detail;

- Someone at PwC purportedly was provided with various reports prepared by confidential witnesses about material weaknesses in Leap's internal controls and revenue recognition policy—another vague allegation that lacks the detail required by the Reform Act;
- Reports allegedly provided to the PwC audit team "detailed Leap's non-compliance with SOX [the Sarbanes-Oxley Act] relating to the Company's financial reporting of revenue and subscribers and its internal controls deficiencies"—another generic reference to reports that are not described in sufficient detail;
- There was "no integration between Leap's Billing System and Provisioning System"—an allegation that does not detail the significance for financial reporting or for the auditors;
- Leap's "Minutes Reports documented the improper revenue recognition practices at the Company"—another nonspecific allegation that does not provide such important detail as what was actually said about the revenue recognition practices;
- "PwC was provided assessments by outside auditing consultants which detailed improper revenue recognition and material undisclosed internal control defects and weaknesses and had been uploaded into the Oracle Accounting Database"—again, no particularized facts such as what the "assessments" actually said, who at PwC supposedly received them, when they received them, or why it mattered that they were allegedly loaded into the database.

Id. According to Plaintiff, these "red flags" support the conclusion that PwC must have intended to deceive Leap's shareholders when it issued its 2006 Audit Opinion.

As discussed further below, nowhere in the Complaint does Plaintiff describe in any detail the substance of the reports PwC supposedly received. Plaintiff does not specify when the reports were delivered other than to say it was during PwC's audit of Leap's 2006 financial statements. Plaintiff does not identify, by name or position, who delivered the reports or who at PwC received them. Plaintiff relies heavily on confidential witnesses for its allegations, but provides no meaningful information about those witnesses' interactions with PwC, or, with respect to several of the confidential witnesses, whether there even were such interactions. *See, e.g.*, *id.* ¶ 13 ("CW#3 also brought the evidence of improper revenue recognition in the Minutes Reports and financial reporting systems to the attention of PwC during the course of PwC's 2006 audit of Leap."); ¶ 47 ("These discrepancies were brought to the attention of PwC during the course of the audit of Leap's 2006 financial statements."); *id.* ¶ 49 ("CW#5's reports regarding Leap's SOX non-compliance during the Class Period were provided to Defendant PwC for its review in connection with its audit of Leap's fiscal year 2006 financial statements."); ¶ 130 (same).

These alleged facts do not add up to a strong inference of intent.

III. ARGUMENT

A. The Reform Act and Rule 9(b) Impose a High Pleading Standard on Plaintiff.

Plaintiff's sole claim against PwC is for an alleged violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j. To establish a violation of Section 10(b), a plaintiff must prove (1) material misrepresentations or omissions by the defendant; (2) made with scienter; (3) that the misrepresentation or omission was made in connection with the purchase or sale of a security; (4) that the plaintiff relied upon the misrepresentation or omission; (5) economic loss; and (6) loss causation. *See Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 341-42 (2005). As the Supreme Court recently emphasized, no relief is available under Section 10(b) beyond the "narrow dimensions" of the claim's rigorous and demanding elements. *See Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 774 (2008). For Section 10(b) purposes, the Supreme Court has defined "scienter" as a "mental state embracing *intent* to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193-94 n.12 (1976) (emphasis added). Recklessness satisfies scienter only to the extent that it reflects some degree of intentional or conscious misconduct. *In re Silicon Graphics*, 183 F.3d at 976-77.

The Reform Act significantly altered the pleading requirements in private securities fraud litigation by requiring that a complaint plead with particularity both falsity and scienter.

In re Vantive Corp. Sec. Litig., 283 F.3d 1079, 1084 (9th Cir. 2002) (citing *Ronconi v. Larkin*, 253 F.3d 423, 429 (9th Cir. 2001)); 15 U.S.C. § 78u-4(b)(2) (requiring plaintiff bringing Securities Exchange Act claim to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind"). These "[e]xacting pleading requirements are among the control measures Congress included in the PSLRA." *Tellabs*, 127 S. Ct. at 2504; *In re Silicon Graphics*, 183 F.3d at 988. Plaintiff has not complied, and cannot comply, with the Reform Act's requirement that it plead particularized facts giving rise to a strong inference of knowingly fraudulent conduct.

Plaintiff's 10(b) claim also must satisfy Federal Rule of Civil Procedure 9(b), which requires Plaintiff to allege "the who, what, when, where, and how: the first paragraph of any newspaper story." *DiLeo v. Ernst & Young*, 901 F. 2d 624, 627 (7th Cir. 1990); *see also In re Hansen Natural Corp. Sec. Litig.*, 527 F. Supp. 2d 1142, 1153 (C.D. Cal. 2007). As explained below, those requirements are missing here.

A claim must be dismissed where the complaint fails to set forth the "grounds" of plaintiff's "entitlement to relief." *Bell Atl. Corp. v. Twombly*, 127 S. Ct. 1955, 1964-65 (2007) (internal quotation marks omitted). Plaintiff's obligation to provide these grounds "requires more than labels and conclusions, and a formulaic recitation of the elements of a cause of action will not do." *Id.* While a court must accept as true all material allegations in the complaint, a court need not accept as true unreasonable inferences or conclusory legal allegations cast in the form of factual allegations. *In re Juniper Networks, Inc. Sec. Litig.*, 542 F. Supp. 2d 1037, 1045 (N.D. Cal. 2008) (citing *Papasan v. Allain*, 478 U.S. 265, 268 (1986) and *McGlinchy v. Shell Chem. Co.*, 845 F.2d 802, 810 (9th Cir. 1988)).

B. Plaintiff Has Not Met the Heightened Pleading Standard Because It Has Not Alleged Facts That Create a Compelling Inference That PwC Intended to Defraud the Proposed Class.

The Reform Act and Rule 9(b) require Plaintiff to provide detailed facts that compel a strong inference that PwC intended to defraud the proposed class by allowing its opinion to be included in the Company's Form 10-K for 2006. As the Supreme Court recently explained, an inference will only qualify as "strong," and thus survive the threshold inquiry for sufficiency under a motion to dismiss, if that inference is "more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent." *Tellabs*, 127 S. Ct. at 2504-05, 2510. The court therefore "must consider, not only inferences urged by the plaintiff . . . but also competing inferences rationally drawn from the facts alleged." *Id*. at 2504.[4] It is not enough for Plaintiff to state facts giving rise to a mere speculative inference of deliberate recklessness, or even a reasonable inference of deliberate recklessness. The PSLRA requires that Plaintiff "plead, in *great detail*, facts that constitute strong circumstantial evidence" that each of the Defendants acted with at least deliberate recklessness. *Silicon Graphics*, 183 F.3d at 974, 985 (emphasis added).

1. Allegations of Accounting Mistakes or Negligence Do Not Satisfy the Pleading Standard.

Plaintiff suggests that the mere fact that a restatement was issued is sufficient to plead its claim. Compl. ¶ 35. But financial statement errors do not equate to a showing of scienter. *DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385, 390 (9th Cir. 2002) ("publication of inaccurate accounting figures, or a failure to follow GAAP," standing alone, is insufficient to establish scienter) (internal quotation marks omitted); *In re Northpoint Commc'ns Group, Inc. Sec. Litig.*, 184 F. Supp. 2d 991, 998 (N.D. Cal. 2001) ("[T]he necessary scienter is in general not established merely by the publication of inaccurate accounting figures, or failure to follow generally accepted accounting principles."). There is a world of difference between mere inaccuracy—or even negligence—and fraud, and to infer fraud from error would be not only illogical, but also contrary to the Reform Act and controlling authority.

Moreover, when a Section 10(b) claim is asserted against an auditor, the facts must establish that the defendant employed practices "so deficient that the audit amounted to *no*

[4] *Tellabs* did not establish new law in the Ninth Circuit, as the Supreme Court adopted the analysis already in use in this circuit. *See Gompper v. VISX, Inc.*, 298 F.3d 893, 897 (9th Cir. 2002) (finding that to enforce the Reform Act pleading requirements "when determining whether plaintiffs have shown a strong inference of scienter, the court must consider *all* reasonable inferences to be drawn from the allegations, including inferences unfavorable to the plaintiffs"); *Middlesex Ret. Sys. v. Quest Software Inc.*, 527 F. Supp. 2d 1164, 1181 (C.D. Cal. 2007) (noting that *Tellabs* explicitly approved the Ninth Circuit's *Gompper* standard).

audit at all." *In re Software Toolworks Inc.*, 50 F.3d 615, 628 (9th Cir. 1994) (emphasis added). This court has emphasized the difficulty of satisfying the scienter standard in the context of an audit:

> Aside from the substantive definition of scienter and the [PSLRA's] stringent pleading requirements, several additional obstacles impede the path of a plaintiff who seeks to sue an independent accounting firm for violating Section 10(b). . . . [T]he lack of a rational economic incentive for an independent accountant to participate in fraud, the client's central role in providing information to the accountant, and the complex professional judgment required to perform an audit, make it exceedingly difficult for a securities plaintiff to plead facts suggesting that an independent accountant acted with the deliberate state of mind now required to withstand a motion to dismiss.

Reiger v. PricewaterhouseCoopers LLP, 117 F. Supp. 2d 1003, 1007-08 (S.D. Cal. 2000), *aff'd*, *DSAM Global Value Fund*, 288 F.3d 385; *see also Batwin v. Occam Networks, Inc.*, No. CV 07-2750, 2008 WL 2676364, at *18 (C.D. Cal. July 1, 2008) ("[S]cienter requires more than a misapplication of accounting principles. The plaintiff must prove that the accounting principles were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts.") (quoting *DSAM Global Value Fund*, 288 F.3d at 390); *In re Wet Seal, Inc. Sec. Litig.*, 518 F. Supp. 2d 1148, 1162-63 (C.D. Cal. 2007) (same). GAAP violations alone, "even *deliberate* GAAP violations do not by themselves establish scienter." *In re Wet Seal*, 518 F. Supp. 2d at 1163.

Plaintiff implicitly acknowledges this case law by alleging that "PwC's work was so deficient that the firm had no basis whatsoever to express legitimately any opinion concerning Leap's financial statements" and that "PwC's audit was materially flawed, so as not to amount to an audit at all." Compl. ¶¶ 170, 35. But those bare allegations are devoid of the particularized support that is required under the Reform Act. They are recitations of Plaintiff's conclusions, not allegations of particular facts. In connection with discovering the accounting errors corrected in the Restatement, Leap identified internal control material weaknesses that had existed as of December 31, 2006. This sequence of events does not suggest that PwC was deliberately reckless in issuing its prior audit opinion on management's prior assessment that internal controls were adequate.

There is no detail in the Complaint about PwC and its audit procedures. The facts that are alleged do not come close to satisfying the heightened pleading standard for scienter. For example, Plaintiff alleges that PwC "fail[ed] to adequately plan its 2006 audit of Leap and to design procedures to search for and detect the existence of material misstatements caused by error or fraud." Compl. ¶ 179. First, that allegation is, again, nothing more than a conclusion. There is no discussion of how the audit plan was deficient, what procedures were performed improperly, or what procedures were supposedly skipped that should have been followed. Plaintiff's allegation reduces to the false and oft-rejected syllogism that a restatement was necessary, therefore the audit must have been flawed. Further, even assuming a flawed audit, this does not support an inference of intentional conduct. *See, e.g.*, *In re Wet Seal*, 518 F. Supp. 2d at 1163 (GAAP violations alone do not by themselves establish scienter); *DSAM*, 288 F.3d at 391 ("Negligence, even gross negligence, does not rise to the level of the nefarious mental state necessary to constitute securities fraud under the PSLRA and *Silicon Graphics.*"). Likewise, Plaintiff alleges that PwC violated industry standards because "due professional care was not exercised in the performance of its audits and the preparation of its audit." Compl. ¶ 181; *see also id.* ¶ 188 ("PwC failed to properly plan the Leap audit[.]"). These conclusions do nothing more than allege that PwC conducted its audit negligently. While PwC denies that it was negligent in its audit, for purposes of this motion there is no need to resolve that question. Negligence is not enough to state a claim under Section 10(b). *Hochfelder*, 425 U.S. at 193 n.12; *In re Silicon Graphics*, 183 F.3d at 976-77. Plaintiff must allege that PwC acted with an intent to defraud.

2. Plaintiff's Cursory Allegations Concerning Reports and Information PwC Supposedly Received Are Insufficient to Show Scienter.

Plaintiff contends that alleged "red flags" show that PwC had the required state of mind. Courts have described "red flags" as "those facts which come to the attention of an auditor which would place a reasonable auditor on notice that the audited company was engaged in wrongdoing to the detriment of its investors." *Garfield v. NDC Health Corp*., 466 F.3d 1255, 1268 (11th Cir. 2006); *Reiger*, 117 F. Supp. 2d at 1008 (describing red flags as "suspicious and conspicuous warning signs"). None of the supposed "red flags" alleged by Plaintiff come close to supporting a strong inference of fraud or indicating that fraud by PwC is as plausible an explanation for the restatement as other possible explanations.

"Red flags" are not known, ordinary factors potentially affecting a company's financial statements. Thus, for example, the allegation that "revenue and related financial reporting was a particularly high risk area for Leap given its subscriber base" cannot be categorized as a "red flag" because—even assuming this were true—it would not put PwC on notice that the Company had made any accounting errors, much less engaged in any wrongdoing in connection with its accounting. Compl. ¶ 36(a). The nature of Leap's subscriber base and any attendant revenue risk says nothing about PwC's mindset. Likewise, the mere fact that the Company hired outside accounting, auditing, and technical consultants to assist the Company in its accounting and compliance functions does not support any inference that PwC would be alerted to material GAAP errors. Compl. ¶ 36(b). The allegation that the Company's decision to augment its expertise is a "red flag" of material error stands contrary to reason. The much more compelling inference is that hiring these consultants demonstrated that the Company was acting to ensure that all financial reporting was done properly.

The other "red flags" identified by Plaintiff are similarly insufficient to show scienter.

Alleged reports regarding weaknesses in financial reporting, internal controls, and revenue recognition practices from Management to PwC (Compl. ¶ 36(c)). Plaintiff contends that PwC "was advised by Defendant Burton and Accounting Executives Lu and Young of material weaknesses in Leap's financial reporting, internal controls and improper revenue recognition practices as presented to them by outside consultants." *Id.* ¶ 36(c). A close reading of the Complaint reveals Plaintiff's sleight of hand. The conclusory allegation in Paragraph 36(c) is followed by a citation to several other paragraphs in the complaint. But only one of those paragraphs even mentions PwC. And that paragraph says nothing about communications between Burton, Lu, or Young and PwC. *See id.* ¶ 13. Nowhere are those communications described with any more detail. There is no discussion of what was said, when those individuals said it to PwC, or who at PwC was involved in the communications. Without this information, it is impossible to draw any inference whatsoever about PwC's mental state following such supposed conversations, much less a strong inference of deliberate misconduct.

SOX assessment and 404 Compliance Reports (SOX Testing Reports) (Compl.¶ 36(d), (e)). Plaintiff also alleges that PwC was provided with SOX assessments and 404 Compliance Reports that "appraised [sic] PwC of material weaknesses in Leap's internal controls and improper revenue recognition practices throughout the Class Period."[5] *Id.* ¶ 36(d). Securities fraud plaintiffs who base their claims on internal reports must provide corroborating details about those reports, including their contents, who prepared them, who reviewed them, and from whom the information was obtained. *In re Silicon Graphics Inc.*, 183 F.3d at 985. The Ninth Circuit has explained that "[t]he reason for requiring such detail was that every sophisticated corporation uses some kind of internal reporting system . . . , and that allowing a plaintiff to go forward with a case based on general allegations of negative internal reports would expose all those companies to securities litigation whenever their stock price dropped." *In re Vantive Corp. Sec. Litig.*, 283 F.3d 1079, 1087-88 (9th Cir. 2002) (internal quotation marks omitted); *see also In re Dura Pharms., Inc. Sec. Litig.*, 548 F. Supp. 2d 1126, 1132 (S.D. Cal. 2008) (same). The same is true here. In the relevant period, essentially all public companies generated SOX testing and compliance reports.[6] Plaintiff therefore must allege specifics from those alleged internal reports as well as facts indicating their reliability. *In re Silicon Graphics Inc.*, 183 F.3d at 985 ("We would expect that a proper complaint which purports to rely on the existence of internal reports would contain at least some specifics from those reports as well as such facts as may indicate their reliability."); *In re Skechers USA, Inc. Sec. Litig.*, 273 F. App'x 626, 627-28 (9th Cir. 2008) ("The complaint, however, fails to describe with any detail the contents of these interim reports, who drafted them, or how the confidential witnesses were in a position to know that the defendants received the alleged reports.").

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[5] The phrase "throughout the Class Period" in this allegation suggests that Plaintiff is referring to internal controls and accounting practices post-dating PwC's 2006 Audit Opinion. But PwC's 2006 Audit Opinion spoke to conditions at the Company "as of December 31, 2006," and not any point later in time. Compl. ¶ 156.

[6] *See* Christopher Cox, Chairman, Sec. Exch. Comm'n, Testimony Before the U.S. House Committee on Financial Services: Testimony Concerning the Impact of the Sarbanes-Oxley Act (Sept. 19, 2006), http://www.sec.gov/news/testimony/2006/ts091906cc.htm (describing contemporaneous requirements under Sarbanes-Oxley).

Here, the Complaint completely lacks the corroborating details necessary to create an inference of scienter, let alone a strong one. The Complaint does not explain the "who, what, when, where, and how" of these reports. *DiLeo*, 901 F. 2d at 627. It does not provide any specifics explaining what deficiencies these reports supposedly identified, who at PwC received these reports, or when they were received, or how these reports were received by PwC, or what communications, if any, surrounded them. As to whether the reports were even provided to PwC, the only allegation consists of the following:

> CW#5 reported these [unspecified] findings directly to Defendant Burton and Assistant Controller Lu and Director of Internal Auditing Young on a weekly basis, as well as to the managers of the departments responsible for preparation of the reports tested. Moreover, CW#5's reports regarding Leap's SOX non-compliance during the Class Period were provided to Defendant PwC for its review in connection with its audit of Leap's fiscal year 2006 financial statements.

Compl. ¶ 49. These boilerplate allegations of PwC's access to unspecified documents—without any specifics about who provided the document, who received the documents, or what they said—do not create a strong inference of deliberate misconduct by PwC.

Leap's daily, weekly, and monthly Minutes Reports (Compl. ¶ 36(g)). Plaintiff's allegations concerning monthly Minutes Reports are similarly deficient. Plaintiff fails to allege with particularity who at PwC was provided these documents and when such documents were provided. *See* Compl. ¶ 62 (indicating that the reports were distributed to the Management Defendants, as well as directors, managers, senior staff and Accounting Executives, but not stating that they were provided to PwC). Plaintiff does not provide any specifics as to how these reports serve as evidence that PwC acted with deliberate recklessness in conducting its audit.[7] Even if a close examination of these unspecified reports somehow would have revealed material deficiencies associated with revenue recognition, there is no basis to infer that PwC overlooked any such information with any intent to mislead investors. The purported existence of these unspecified reports without more does not qualify as a red flag, and it does not support a strong inference that PwC acted with deliberate recklessness in conducting its audit.

The alleged lack of "integration between Leap's Billing System and Provisioning System" (Compl. ¶ 36(f)). Plaintiff asserts that PwC should have viewed with suspicion an alleged "disconnect" between Leap's billing system and its "Provisioning System." *Id.* ¶ 36(f). But again, Plaintiff's allegation says nothing about PwC's mental state. While Plaintiff alleges that PwC knew of this purported "disconnect," there are no specifics as to how the alleged "disconnect" supposedly resulted in any material misstatement of revenue, much less PwC's mental state in issuing its Audit Opinion. *Id.* ¶ 9. For example, even assuming that there was a "disconnect" and PwC was aware of it, the Complaint does not specify whether PwC intended for Leap's revenue to be reported inaccurately, proceeded recklessly in the face of any "red flag," negligently failed to appreciate the significance of the disconnect, or relied on other safeguards and procedures to guard against any risks associated with the "disconnect." Plaintiff has not alleged particularized facts creating a strong inference that PwC acted with intent to deceive.

Assessments by outside auditing consultants (Comp. ¶ 36(h)). Plaintiff next contends that "PwC was provided assessments by outside auditing consultants which detailed improper revenue recognition and material undisclosed internal control defects and weaknesses and had been uploaded into the Oracle Accounting Database." *Id.* ¶ 36(h). In an effort to create the appearance of detail, that allegation is followed by a list of other paragraphs in the Complaint, suggesting that those other paragraphs relate to PwC receiving the alleged "assessments." But

[7] The Complaint explains that the "Daily Minutes Reports were shorter, less detailed summaries which provided the Senior Executives . . . with a daily snap-shot of the Company's subscriber totals and service revenue. Weekly and monthly Billing System reports were more detailed, and included a specified sampling data from newly launched and existing markets. . . ." Compl. ¶ 62.

none of those paragraphs even mentions PwC. A search of the Complaint finds no allegations that could possibly survive a motion to dismiss. For example, Plaintiff alleges that "CW#3 also brought the evidence of improper revenue recognition in the Minute Reports and financial reporting system to the attention of PwC during the course of PwC's 2006 audit of Leap." *Id.* ¶ 13. Later the allegations change subtly: "In connection with the year end and fiscal 2007 quarterly financial statements, CW#3 brought to the attention of Young, Lu, Gray and Bergener . . . discrepancies between recognized revenue and the 'cash' actually received for the provision of services . . . . These discrepancies were brought to the attention of PwC[.]" *Id.* ¶ 47. Thus, the Complaint is far less than clear about who provided PwC with this information, if at all. And it again fails to provide any detail about when and to whom at PwC these assessments were provided. Moreover, the Complaint only provides the most conclusory descriptions of the assessment's details. They provide no basis to support a strong inference of scienter on PwC's part.

Moreover, the so-called "red flags" are based largely on vague assertions attributed to confidential witnesses. In evaluating similar allegations, the Sixth Circuit held in an opinion issued this week that the alleged "red flags" did not support a strong inference of scienter. *Ley v. Visteon Corp.*, No. 06-2237, slip. op. (6th Cir. Aug. 26, 2008). *See* Phillips Decl. Ex. F. The court reasoned that:

> Because this allegation lacks specificity and originates from an anonymous source, we are not inclined to give it much weight in our analysis. Moreover, Plaintiffs fail to allege particularized facts about the who, what, where, when, and how of what PwC knew or disregarded about [the company's] accounting practices, rendering the statement even less probative of scienter.

Id. at 14 (citation omitted). The same is true here.

Plaintiff's assertion that PwC ignored "red flags" of any accounting errors or material weaknesses in internal controls does not bear up under scrutiny of the underlying allegations. There is no reason to draw any inference of PwC's intent from these allegations.

3. Plaintiff's Allegations Must Be Steeply Discounted Because of Plaintiff's Reliance on Confidential Witnesses.

Courts have expressed skepticism where securities plaintiffs rely extensively on allegations of confidential witnesses. *See, e.g.*, *Silicon Graphics*, 183 F.3d at 985 (noting that plaintiff had not identified the sources of allegations about internal reports); *In re Skechers USA, Inc.*, 273 F. App'x at 627-28 (plaintiff failed to identify how confidential witnesses knew defendants received reports). As Judge Easterbrook observed in *Higginbotham v. Baxter International, Inc.*, 495 F.3d 753, 756-57 (7th Cir. 2007), allegations that depend on statements by confidential witnesses should be steeply discounted under the Reform Act pleading standard. "It is hard to see how information from anonymous sources could be deemed 'compelling' or how we could take account of plausible opposing inferences. Perhaps these confidential sources have axes to grind. Perhaps they are lying. Perhaps they don't even exist." *Id.* at 757; *see also Ind. Elec. Workers' Trust Fund IBEW v. Shaw Group, Inc.*, __ F.3d __, 2008 WL 2894793, at *4 (5th Cir. July 29, 2008) (after *Tellabs* "courts must discount allegations from confidential sources" because "[s]uch sources afford no basis for drawing the plausible competing inferences").

Plaintiff relies on confidential witnesses ("CWs") throughout the Complaint. Inconsistencies and lack of detail in the allegations about those witnesses undercut any inference that could possibly be drawn from them. For example, Plaintiff alleges that "[t]hroughout 2006 and 2007, CW#1 and CW#4 regularly reported to the Management Defendants that these short-cuts resulted in two common discrepancies in the Minutes Reports." Compl. ¶ 67. However, according to the Complaint, CW#1 was employed by Leap from July 2005 through November 2005, thus ending his relationship with the Company before the alleged Class Period even starts in 2006 and CW#4 was retained as a consultant for Leap from July 2006 to November 2006. *Id.* ¶¶ 45, 48. The description of the witnesses' interactions with PwC is so brief that it is impossible to draw any inference about PwC's state of mind from it. *Id.* ¶ 13 ("CW#3 also brought the evidence of improper revenue recognition in the Minute Reports and financial reporting systems to the attention of PwC during the course of PwC's 2006 audit of Leap.") Cases in which courts have concluded that complaints that rely on anonymous sources are sufficient under the heightened pleading standard of the Reform Act involve far more detailed allegations. *Cf. Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 711-12 (7th Cir. 2008) ("*Tellabs II*") (holding that Reform Act pleading standard was satisfied and noting that, unlike in *Higginbotham*, allegations about confidential witnesses were set forth in "convincing detail" and "corroborated by multiple sources").

4. The Pattern of Prior Disclosures Creates a Compelling Inference That PwC Did Not Have the Required Intent to Deceive Investors.

Under *Tellabs*, courts "*must* consider competing inferences arising from the facts as pled in order to determine whether Plaintiffs have created the requisite 'strong inference' of scienter." *In re Guidant Corp. Sec. Litig.*, 536 F. Supp. 2d 913, 932 (S.D. Ind. 2008); *Tellabs*, 127 S. Ct. at 2504. Here there are judicially noticeable facts that weigh against any inference that PwC intended to deceive investors. First, Plaintiff has not identified any reason that PwC would risk its reputation by covering up internal control deficiencies that it knew existed at the Company. Second, the extensive disclosures in prior periods about material weaknesses in internal controls strongly suggest that when material weaknesses in internal controls were identified, they were disclosed, including by PwC. It would make no sense for PwC to have issued an opinion in 2005 agreeing with management's assessment that there were material deficiencies and then to start abruptly "covering up" such deficiencies in 2006. Plaintiff offers no theory why PwC would suddenly have engaged in a fraud to conceal material weaknesses when material weaknesses had been continuously disclosed for more than a year prior to the issuance of its 2006 Audit Opinion. Plaintiff's speculation that an intent to defraud was behind the change in PwC's opinion makes far less sense than the conclusion that PwC believed that by the year-end 2006 the Company had adequately addressed the material weaknesses in its internal controls.

The most plausible inference from the allegations in the Complaint and undisputed facts is that the Company and PwC (i) sought to identify weaknesses in the Company's internal controls, (ii) disclosed the material weaknesses that were identified, (iii) sought to remediate those weaknesses (in part through enlisting additional outside support), (iv) believed the weaknesses had been remediated, (v) later determined there were errors in the financial statements and that additional weaknesses in controls existed, and (vi) disclosed those errors and weaknesses in the restatement announcements. Plaintiff's fraud theory makes far less sense and is not supported by specific allegations that would create an equally strong inference of fraud. Because Plaintiff's contentions that PwC was intending to take part in a fraud are less compelling than an inference of nonfraudulent behavior, its Complaint does not meet the heightened pleading requirements of the Reform Act. *Tellabs*, 127 S. Ct. at 2504-05 (inference raised by securities plaintiffs' allegations does not satisfy Reform Act unless it is "at least as compelling as any opposing inference of nonfraudulent intent").

5. Plaintiff's Claim Against PwC Fails Because Plaintiff Does Not Allege That Anyone at PwC Had the Required Intent.

Another fatal deficiency in Plaintiff's allegations is the complete absence of specificity as to who at PwC supposedly had the required intent to defraud. The Complaint does not refer to any particular member of PwC's audit team, and there is no discussion as to who at PwC knew what and when they knew it. Without particularized allegations as to the state of mind of individuals at PwC, Plaintiff has not adequately pled that PwC had the required intent. *See In re Apple Computer, Inc.*, 127 F. App'x 296, 303 (9th Cir. 2005) (affirming dismissal of securities claim against corporation because plaintiff had not alleged that the individual corporate officer making the statement had the requisite scienter at the time the statement was made) (citing *Nordstrom, Inc. v. Chubb & Son, Inc.*, 54 F.3d 1424, 1435-36 (9th Cir. 1995)).

C. Plaintiff Cannot Assert a Claim Against PwC That Is Not Tied to Any Alleged Misstatement by PwC.

1. Plaintiff's Sweeping References to "Defendants" Fail to Specify Any Statement by PwC.

In many places in the Complaint, Plaintiff makes sweeping references to "Defendants" as a group, without making any effort to distinguish which particular Defendants are being discussed. *See, e.g.*, Compl. ¶¶ 9, 135, 195-96. Frequently it is apparent that Plaintiff cannot mean to be referring to PwC, because, for example, the allegation is discussing statements in earnings releases or quarterly filings (with respect to which PwC did not make any public statements). *See, e.g.*, *id.* ¶¶ 117, 133, 135. To the extent Plaintiff may contend that PwC was intended to be included in its loose use of the term "Defendants," it has failed to state a claim because it has not alleged a misstatement by PwC. Moreover, those allegations fail to include any particularized facts about PwC and therefore do not meet the pleading standard that applies here. *See, e.g.*, *In re Finisar Corp. Deriv. Litig.*, 542 F. Supp. 2d 980, 996 (N.D. Cal. 2008) (dismissing claims against defendant where plaintiffs' bare and conclusory allegations failed to identify any specific misconduct by that defendant).

2. Plaintiff Cannot State Any Claim Against PwC for the Period Prior to March 1, 2007.

The claim against PwC should be dismissed in its entirety because Plaintiff has not met the pleading standards of the Reform Act and Rule 9(b). Even if it were to survive, however, the claim against PwC would be limited to a narrow time period. Because Plaintiff lumps Defendants together, the Complaint as currently drafted could be read as asserting claims against PwC for periods prior to March 1, 2007 (the first date that any statement by PwC was publicly disclosed). The proposed class period extends from June 30, 2006 to November 9, 2007. But shareholders who purchased between June 30, 2006 and February 28, 2007 have no claim against PwC because PwC is not alleged to have made any public statements during that time period. As noted above, PwC did not issue any public statements in connection with any of the Company's quarterly filings. The only statement by PwC that is identified in the Complaint is its opinion that was included with the 2006 Form 10-K filed on March 1, 2007. Because Plaintiff alleges *no* statement by PwC prior to March 1, 2007—much less a false statement as required to state a claim under Section 10(b)—Plaintiff has not stated a claim against PwC for that time period. To the extent the current Complaint could be read as asserting a claim against PwC for the time period prior to March 1, 2007, that claim should be dismissed.

IV. CONCLUSION

The few allegations in the Complaint that relate to PwC do not create a strong inference that PwC acted with any intent to defraud investors when it issued its 2006 Audit Opinion. Accordingly, because Plaintiff has not met the heightened pleading standard that applies to its claim, Plaintiff's claim against PwC (Count I) should be dismissed. If the Court allows the claim to go forward, or allows Plaintiff to amend its Complaint, it should dismiss with prejudice any claim against PwC by purported class members who purchased securities prior to March 1, 2007, the first date of any alleged statement by PwC.

DATED: August 28, 2008

Respectfully submitted,

HELLER EHRMAN LLP

By /s/ Lori Lynn Phillips

GEORGE E. GREER (*admitted pro hac vice*)
LORI LYNN PHILLIPS (*admitted pro hac vice*)
JOSHUA B. SELIG (*admitted pro hac vice*)
HELLER EHRMAN LLP
701 Fifth Avenue, Suite 6100
Seattle, WA 98104-7098
Telephone: (206) 447-0900
Facsimile: (206) 447-0849
george.greer@hellerehrman.com
lori.phillips@hellerehrman.com
joshua.selig@hellerehrman.com

CHAD R. FULLER (Bar No. 190830)
HELLER EHRMAN LLP
4350 La Jolla Village Drive, 7th Floor
San Diego, CA 92122-1246
Telephone: (858) 450-8400
Facsimile: (858) 450-8499
chad.fuller@hellerehrman.com

Attorneys for Defendant
PricewaterhouseCoopers LLP

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